

# Economic Policy Review

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## Let's See Who Supports Low Just Taxes For All

Svetla Kostadinova

The 10% flat income tax that was announced in principle by the ruling coalition in the end of July 2007 is one of the best decisions so far made. The mixed reactions in regard to flat tax idea are a consequence of several constellations.

The **vagueness** about the details and design of the flat income tax can be a double-edged sword. It can make room for discussion in which the best solution is chosen. On the other side, interest groups, depending on the future design, can try to hinder the implementation that would not benefit the society. There is a chance also for delay or even reconsideration of the idea, or certain concessions to be made so the idea is changed substantially. Therefore, it is important to know the details as soon as possible.

Current **tax deductions** and government plans to abolish them provoke angry reactions from affected groups which is normal. However, this should not distract us from the overall positive effect on economy from low flat income tax introduction.

Government' plans to **compensate** the most affected low-income workers are still not clear and this is important for the ruling coalition because of the forthcoming local elections in the autumn and its capacity to defend its ideas.

**Opposition parties' reactions** should not be underestimated, at least because they are unique. For the first time we see how a reasonable idea

that so far has been proposed by the opposition, now is questioned by itself. Whatever the reasons for such behavior, it is clear that there are few economic ideas that would lead to overall prosperity, and altogether be supported by all political parties.

Below we will try to describe the reactions and our solutions regarding 10% flat income tax as proposed at the moment – no tax deductions, no minimum non-taxable income and abolishing of all preferences.

### The affected groups are the following:

1) Employees working under labour contract with monthly **salary up to 400 leva** (205 euro) – the official statistics shows that in the first three months of 2007 workers in agriculture, refining industry, construction, tourism, real estate, trade and repair, and education have average salary less than 400 leva.(the data is average but is the only one available). It is obvious that despite the “education” and at some extent “agriculture”, all other sectors have high growth rates of investments in recent years, the labor demand is constant and shadow production still significant. It is widely known that people in the above mentioned industries receive at least 50% more than the official salary. On the other hand, education sector is under the control and management of the state and municipalities and they will be compensated by the measures planned when introducing the flat tax. If we extract employed in these five sectors there are 872 410 workers with less than 400 leva

monthly salary or 37.8% of total employed in the country.

The **solution** for this group so it wouldn't be negatively affected is higher decrease of the social security contributions – by 10% instead of 3% as planned. This way, the increased income taxation of 400 leva and below earners will be not only compensated, but there will be an increase of their disposable income.

2) Employees working under labour contract with monthly **salary higher than 400 leva** – it is hard to say how many workers fall in this category. The official numbers are that people working in refinery, electricity, transport, telecommunications, financial intermediation, state administration, healthcare and social activities receive more than 400 leva per month. If we add employees in construction, real estate and half of workers in trade we end up with 1 111 834 people or 53.9% of total.

This group clearly benefits from 10% flat income tax.

3) **Liberal professions** working under civic contracts and people receiving copyright and license royalties – there is no official statistics for this group. Nevertheless, the National Social Security Institute data shows that exactly 4% of total social security contributions come from self-employed people. This means that tax revenues are proportionately the same, or 4% that is 52 mln. leva tax revenues out of total. We see how small is this group out of total employed population in Bulgaria.

We should not forget that liberal professions in Bulgaria still enjoy many restrictions to competitions that increase their prices. *Lawyers* still have preferential VAT rate despite National Revenue Office instructions. They enjoy minimum prices determined by the Supreme Bar Office.

*Notaries* also enjoy fixed prices, as well as “guaranteed” work because of the geographical location restriction for notaries’ number per population. *Pharmacists* also have fixed prices, restrictions for profession (length of service requirement, limitation for number of pharmacies owned by one pharmacist). The *auditors and accountants* enjoy fixed prices also.

The **solution** is greater decrease by 10% of social security contributions that will compensate the abolishment of tax deductions available at the moment for this group. This should be the only demand for all liberal professions and not keeping the present situation and rejection of flat tax idea.

4) **State budget** – not surprisingly, despite lack of official estimations and analysis about flat tax reform effects, the result will be at least keeping the budget revenues at current state, and more realistically – increase of income tax revenues.

The overall conclusion is that there are people already paying effectively 10% income tax and they should support that this becomes reality for all workers in Bulgaria that should be combined with further 10% decrease of social security contributions.

We, from the Institute for Market Economics, always have said that:

- tax reform should include tax and social security contributions in order to have real effect
- the basic argument is that people have higher disposable income that they decide by themselves how to spend
- only such comprehensive reform is just and fair, and reduces tremendously the competition for privileges and living on someone else account.

This is how it should be done.

### An example

Below we present the effective labor tax burden of three people:

- 1) employee working under labour contract
- 2) employee working under civic contract
- 3) employee receiving copyright and license royalties income

The three workers receive 1 400 leva monthly salary (716 euro)

2007	Labour contract	Civic contract	Copyright and license royalties income
Salary	1 400	1 400	1 400
Social Security Contributions	412	294	73
Income tax	180	107	62
Total tax burden	592	401	135
As % of salary	42.3%	29%	9.68%

### Interventions On the Grain Market – Will They Last Forever?

Adriana Mladenova

In august 2007 there was a discussion in Bulgaria for the possibility of opening of the State Reserve and supplying the market with wheat at a lower than the market price. Realization of this measure was deterred for now because it should be approved by the European Commission at first. The so-called Intervention Agency, that is a part of the Common Agricultural Policy of EU, aims to „correct“ prices of agricultural products during periods of low prices (due to excessive supply) or vice versa and it operates in the period November 1<sup>st</sup> – March 31<sup>st</sup>. Of course, there is not (just there can't be) a theoretical justification what is “too low” or “too high” price in a market economy with free competition. But a centralized government body decides what the price should be and begins the attempts to govern the market.

The other options for dealing with this year bad crop yield and supplying enough grain for the processing industry and for feeding the animals are: 1) duty-free import from third countries and, 2) purchase of grain from Reserves' of Intervention Agencies in other member states. During scarcity of a good, it is free trade (without quotes, duties and other limitations) that is the most effective pill against sharp increase of prices.

#### Are agricultural producers speculators?

The “Federation of Consumers” in Bulgaria made a statement that the recent increase of wheat and flour prices in the country is due to speculation. However, what does speculation mean? That is taking more risk and expecting higher return in exchange. Thus, agricultural

producers act as all other entrepreneurs and businessmen and follow the market signals. They can only increase the prices to a level that the market can take.

Prices are sensitive to changes in supply and demand, not to someone's idea of fair price. From one side, this summer there is greater demand due to the growth of the economy and development of animal-breeding sector, widening of the market, free access to the Common European market (custom duties within the EU were abolished), and on the other side – there is less supply due to the bad yield, petrol prices grow up, labor prices – as well. The interventions can only lead to distortions, creation of culture of dependency, rent-seeking behavior and taking economically wrong decisions on the market as a result.

Here it is what the Prime Minister of Romania Calin Popescu replied to the question whether he could do something to stop the increase in the price of wheat in Romania: „*We are in a market economy. What do you want me to do? Romania will not return to controlled prices. Hardly had we liberalized all products, further to long efforts. We do not introduce measures of administrated prices. I think Europe would laugh at such measure...Prime Minister told the “fair” price of bread only before ‘90s.*“ At the same time, the Prime Minister of Bulgaria, Sergei Stanishev, summons up a supervising commission for control of prices.

#### History repeats

We will look back several years and will follow what happened on the grain market right after the harvesting season of wheat – from July to October.

**2003** – the wheat yield is poor due to bad climate conditions. Producers ask 153 Euro for a

ton of wheat on the Commodity Stock Exchange, but real deals are made at 133 Euro per ton during the summer months. At the same time, farmers insist for compensations from the state for the bad yields, while animal-breeding farmers and bread producers request the state to intervene on the market to push down the prices. In September there is a ban for export of wheat and flour aiming to „protect the domestic consumption“. About 200 thousand tons of wheat is released from the State Reserve. Despite this, the price of the wheat reached 177 Euro per ton in December.

**2004** – the yield is good, the supply increases, which pushes the prices down. The average bid price for the season is 81 Euro per ton or 50% less than last year price. The state intervenes in order to increase the price and purchases through the State Reserve 170 thousand tons of wheat at a higher price than the average market price.

**2005** – floods and heavy rains during the summer cause damage to some part of the crops and farmers, that are negatively affected, want compensations from the government. The supply is still high and in September the price of the wheat is 71 Euro per ton. The State Reserve purchases 122 thousand tons of wheat at a higher than the market price in order to „activate“ the market and increase prices. At the end of the agricultural year, prices reach 98 Euro per ton.

**2006** – the yield is good. The price of the wheat in August is 81 Euro per ton. The agricultural producers protest and threaten to block the highways due to the low market price. They

want from the government to increase the subsidies and the State Reserve to purchase over 100 thousand tons wheat at a price of at least 100 Euro per ton.

**2007** – the yield is bad again due to dry weather, snowless winter and draughts in the summer months. The ask price on the Commodity stock market reached 200 Euro per ton. The farmers will receive additional grants from the government because of the low yields. Bread producers and animal-breeding farmers insist the government to take action to drop the price of the grain.

**2008** – there are two scenarios. The price will be either too low or too high according to the agricultural producers. However, there is one certain thing – the interested parties again will plead for interventions on the market.

The European Commission not only allows, but actually conducts the ideas of intervention in the market in the sector of agriculture and food industry through the mechanisms of the Common Agricultural Policy – production quotes, subsidies, interventions, export subsidies, grants. Therefore, we should not take it as surprise that farmers year after year have different requests to the government. This, however, does not prove to be a successful strategy, because the sector is lagging behind the other sectors of the economy and agricultural producers get used to receive protection from the state and become dependent on someone else to rule their lives.

## Prices Have Been “Wrong” Again

Veliko Dimitrov

Obviously ruling coalition politicians’ lack of other original pre-election ideas (local elections take place this autumn) just after they proposed 10% flat income tax. What they are now employing in their campaign is nothing but pure populism – promises for lower consumer prices through price control measures could not be anything different. There is however a second

suggestion – more votes are not leading for the prime-minister and the other initiators of this idea and they really believe that are able first to determine and then to force “fair” price relations on the free market. If they really do believe this, all we could do is to offer them a three-day course on price formation and economic policy basics.

Are there any serious reasons for price hysteria? – No. Official data provide us with the following information:

**Consumer price indices by month**

	<b>Accumulated inflation in 2006 – base – December 2005</b>	<b>Accumulated inflation in 2007 – base – December 2006</b>
January	100.8	101.4
February	103.8	101.9
March	104.1	101.8
April	104.6	102.3
May	104.6	102.4
June	102.9	102.0
July	102.4	104.3

*Source: National Statistical Institute*

Even if we assume that the poor crop this year created tensions on the market and pushed prices higher, that is still no reason for serious concern and furthermore for any price control measures. The new relative price relations merely reflect the change in everyone's supply expectations.

What the government should do – nothing (however, it can close down the State reserve, which sole function is as it is already clear the drain of taxpayer's money through buying and selling reserve stock).

And what the government is up to? – deploy a swarm of state officials to inspect and take record of prices, comparing and analyzing them – the so called Commission for price observations. What this effort will produce is nothing but senseless reports and probably a couple of even more senseless fines. Moreover, this will plant in the feeling that producers and retailers are the bad and consumers are the good (such a demarcation does not really exist because all producers and retailers are consumers as well).

### **What Is In The News For Excise Duties?**

Metodi Lazarov

The hassle, incited by the possible introduction of a flat tax, has diverted the public's attention from noticing the excise duty measures that the government plans on implementing in the next two years. "Europe says so" is one of the favorite excuses of the governing coalition to justify a painful policy that is on the way of being conducted. That being the case, the government feels at ease increasing the excise duties for the period the minimum levels of the European Union are reached and thus, budget revenue also to increase more than proportionally to the insignificant losses from tax cuts. Bulgaria has committed itself to fulfilling the requirements from Chapter 10 "Taxation" of the official negotiations in which the Commission (and to which the Bulgarian side has agreed) has recommended a schedule for the corrections in excise duties. The state, however, is reluctant to be keeping pace to that schedule and does not plan on relieving the whole timing of the process but even will be introducing higher than the required levels. The 2008 Budget which is now in sight confirms that observation and officially pronounces the state's inadequate intentions.

Media have streamed different interpretations of the government's ideas on excise duties. The main plan of the coalition is to level out the excise duties on cigarettes, fuels, coal and coke and energy to the minimum of the EU during the next two years. According to information in newspapers "the excise duty on cigarettes will be increased in two steps – in 2008 and 2009, while fuels will be twitched only once next year", "0.05 leva will be the upward change for fuels in 2008, while cigarettes and alcohol the increase will be halved to what the EU requires". Again according to journalists "next year will surprise us with an increase of 5% of the prices of alcohol and fuels."

- According to Chapter 10's schedule, "Bulgaria could delay the introduction of the minimum excise duty on cigarettes for retail sales (including tax) of the most popular brand till December 31<sup>st</sup>, 2009". That excise duty is currently 42,5 euro for a thousand pieces while the required level is 64 euro. The plan of the government is most likely to increase it to 50 euro in 2008 and to 64 on January 1<sup>st</sup>, 2009. According to our estimations that increase in cigarettes' retail price would add 0.60% to inflation in 2008 and about 1% for 2009. We base

our calculations on the sound effect of the 65% increase on retail price in 2006 which blasted the year's inflation with additional 2.25%. Why the government wants to lose a whole year (January 1<sup>st</sup> – December 31<sup>st</sup> 2009) in the supposedly gentle increase of excise duties?

- According to another paragraph of Chapter 10, "Bulgaria could undertake [the following gratis period] till January 1<sup>st</sup>, 2011 for unleaded petrol...of minimum level of EUR 359 on 1000 litres as the effective tax base on January 1<sup>st</sup>, 2008...must not be lower than EUR 323 on 1000 litres. Currently we are charged 322.12 euro and if the official schedule is to be followed, the excise duty will be fixed on 337.5 euro in 2008 (which is equal to a 5% increase), 350.2 in 2009 and completing the process with 363 euro in 2010. That would mean 4 euro higher excise duty than the minimum or a stotinka unnecessary higher retail price for all of us. If the increase is to be with 0.05 leva in 2008, as some media have announced, then the excise duty would jump up to 347.7 euro which would mean that the government is again wasting a whole year.
- Bulgaria is surpassing with 2% all minimum levels of excise duty on alcohol products while the government is planning on another increase of 5% in 2008, and yet another one in 2009. The minimum level on ethyl alcohol is 550 euro while we are currently being treated with 562.43 euro. The EU has

decided to increase the minimum level to 575 euro for next year which equals to a 2.2% correction of our excise duty if the government were not looking for extra tax revenue.

- There is not much information on the plans for coal and coke but the government will most likely increase the excise duty on non-economic uses (local and central heating) from 0.15 up to 0.3 euro which is again a step back from the schedule. That is a direct blow on all users who use the products as means for heating.
- The government also considers increasing the excise duty on energy (non-economic use) from 0.5 euro up to 1 euro either in 2008 or 2009 – a clear contradiction to the scheduled 2010.

It is quite relevant to ask ourselves why the government is being so hasty with excise duties, considering the fact that the European Monetary Mechanism seems to be put away in time. The coalition is probably trying to squeeze the inflation, inflicted by excise duties, in 2008 and 2009 and eventually go through ERM-II in 2010 and 2011 which will clear the way for an acquisition of the euro in 2012. We wonder who will bear the political responsibility for the unnecessary higher excise duties for a couple of years if we are postponed to let's say 2014. Most likely that will be forgotten as surprisingly easy as this year's increases. Then what should you expect in the next two years – fasten your income belts because the state budget needs to be filled with who-cares-what taxes.

### **E-Invoicing In Denmark - The Right Way!**

Metodi V. Metodiev

Electronic invoicing became mandatory in Denmark on February 1<sup>st</sup>, 2005. All former paper-based invoices sent to government on all levels, from large agencies to nursing schools, are now managed electronically.

Before February 2005 every business would get a paper invoice by post that had to be handled by a number of people in the organization – for approval, entry and filing. Only one person at a

time had access to the invoice and for future reference you had to go and find it in the basement archive.

However, e-invoicing in Denmark is the result of a public/private partnership that makes use of successful and established technology. The set-up for e-invoicing is based on proven market solutions, including the infrastructure and the systems that can receive and process e-invoices. The solution is independent of the companies' IT sophistication and is highly flexible.

Furthermore e-invoicing is essential part of the Danish national strategy for e-government which

aims to create a more effective and coherent public sector. The strategy behind digitalization is that investments must pay off, which means that digitalization projects must either increase the quality of public services (better products, faster case-processing times, fewer errors etc.) and/or supply the same service using fewer resources. E-invoicing is a step towards public procurement that is digital from start to finish. This will mean further efficiency benefits for both the public and the private sector.

The development in the amount of e-invoices received by public institutions shows fast implementation - from zero to 95% within the first 10 month since February 2005.

What are the steps to ensure propriety utilization of e-invoicing?

1. There is special online-based user-friendly electronic platform especially for creating e-invoices;
2. When placing an order, the employee states the specific electronic address of the institution, the EAN number. This ensures that the invoice arrives directly into the electronic invoicing system of the institution, and is subsequently approved online via the employee's PC;
3. When state administration receives e-invoice, now it should proceed the second part of the process;

Companies can send their invoices in different ways, according to their level of IT readiness:

1. Through an electronic invoicing system, by sending an OIOXML digital invoice directly from their own system to their public-sector customer via the VANS network;
2. Through a digital invoice portal, which resembles an Internet bank where companies compose their invoices using

a login and password, and then send it electronically;

3. By sending a paper invoice with an EAN number to a Read-In bureau. Here it is converted to an electronic invoice and forwarded to the correct public institution. This solution ensures that foreign companies and companies without the necessary IT can still do business with the public sector;

What are the benefits of the system?

1. better public services;
2. reducing compliance costs for so-called "old-fashion" procedure;
3. reducing bureaucracy;
4. optimization of working processes;
5. more transparency in public spending;
6. and last but not least reducing corruption practices;

The efficiency benefit of the conversion to e-invoicing itself is estimated at about EUR 120 – 150 million a year. Part of this saving is earmarked for the national treasury. In addition to this comes significant savings in internal administrative processes. E-invoicing contributes to building a digital infrastructure that will benefit the efficiency of society as a whole, in much the same way that railroads and telephone cables have done in the past.

So, that is the right way – be sure!

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